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Supreme Court of the United States

October Term 1950

No. 609

EDWARD N. CLAUGHTON,

Petitioner,

against

STELLA GRATZ, suing as a stockholder in the name and in behalf of MISSOURI-KANSAS-TEXAS RAILROAD COMPANY, MISSOURI-KANSAS-TEXAS RAILROAD COMPANY and UNITED STATES OF AMERICA,

Respondents.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT AND BRIEF

HENRY WARD BEER,
Counsel for Petitioner.

SUPREME PRINTING CO., INC., 41 MURRAY STREET, N. Y., BARCLAY 7-0349

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Supreme Court of the United States

October Term, 1950

No.

EDWARD N. CLAUGHTON,

*Petitioner,**

against

STELLA GRATZ, suing as a stockholder in the name and in behalf of MISSOURI-KANSAS-TEXAS RAILROAD COMPANY, MISSOURI-KANSAS-TEXAS RAILROAD COMPANY and UNITED STATES OF AMERICA,

*Respondents.**

PETITION

To the Honorable, the Chief Justice of the United States and the Associate Justices of the Supreme Court of the United States:

Your petitioner respectfully shows:

Petitioner respectfully prays for a Writ of Certiorari to review a decree of the United States Court of Appeals for the Second Circuit (R. 90)** which affirmed the judgment of the United States District Court for the Southern District of New York wherein the District Court adjudged

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*In the within petition and accompanying brief, petitioner Edward N. Claughton is also referred to as defendant or as defendant-appellant; respondents Stella Gratz and Missouri-Kansas-Texas Railroad Company are also referred to as plaintiffs or as plaintiffs-appellees or in the singular of those designations when separately mentioned.

**Reference is made to pages in the record.

that plaintiff Missouri-Kansas-Texas Railroad Company recover from defendant the sum of $308,417.50, with costs as taxed (R. 61-63).

Summary and Statement of the Matter Involved

This action was instituted on April 4, 1946 by plaintiff Stella Gratz, suing as a stockholder in the name and in behalf of Missouri-Kansas-Texas Railroad Company as plaintiff, against Edward N. Claughton and Missouri-Kansas-Texas Railroad Company as defendants, pursuant to the provisions of Section 16(b) of the Securities Exchange Act of 1934, 15 U. S. C. A. § 78p(b), to recover from the defendant Edward N. Claughton profits allegedly realized by him from dealings in the corporation's securities within periods of less than six months. On April 18, 1948, an order was made naming Missouri-Kansas-Texas Railroad Company as party plaintiff instead of party defendant and amending the action accordingly.

The Securities Exchange Act of 1934 (48 Stat. 881, 15 U. S. C. A. § 78) regulates exchanges and transactions in securities on exchanges or in over-the-counter markets. It provides for the registration with the Securities and Exchange Commission of exchanges and of securities traded on exchanges. It makes certain transactions in securities unlawful. It attaches civil liability to, but does not make unlawful, certain other transactions in securities.

Section 16(a) of the Act requires every person who is directly or indirectly the beneficial owner of more than 10% of any equity security (other than an exempted security) registered on a national securities exchange, or who is a director or an officer of the issuer of such security, to file a statement with the exchange and the Securities and Exchange Commission of the amount of equity securities of which he is the owner, and within ten days after the close of each current month thereafter to file another

statement indicating his ownership and such changes therein as have occurred during such current month.

Section 16(b) of the Act upon which the instant action is predicated, provides in part:

> "For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months."

Particularly exempted from the provision of the statute are (1) transactions where the beneficial owner was not such both at the time of the purchase and at the time of the sale; (2) acquisition of securities in good faith in connection with a debt previously contracted and (3) such securities as the Securities and Exchange Commission may, by rule or regulation, exempt as not comprehended within the purpose of the section.

Plaintiffs rested their choice of venue and their contention that the United States District Court for the Southern District of New York had jurisdiction of the action upon Section 27 of the Securities Exchange Act of 1934 as construed by plaintiffs. The relevant portions of Section 27 are quoted in the accompanying brief.

Defendant Edward N. Claughton was sued herein as such alleged "beneficial owner". No claim was made that

he was an officer or director of the railroad company, and the fact is that he was not an officer or director.

The transactions for which defendant was held accountable extended over a period from December 18, 1944 to December 3, 1947 (R. 53).

Through various notices of motion of defendant Edward N. Claughton served during the period from April 1946 to January 1947 and consolidated into one motion, said defendant moved to dismiss the action for failure to state a claim upon which relief could be granted, improper venue, lack of jurisdiction, and upon constitutional grounds. Said motion was denied by order dated April 15, 1947.

On May 19, 1947, an order was made upon motion of plaintiff Stella Gratz granting summary judgment, pursuant to Rule 56 of the Rules of Civil Procedure, in favor of said plaintiff against defendant Edward N. Claughton, and directing that the cause be referred to Alexander Pfeiffer, Esq., as Master, to take evidenec on the sole issue of damages, and to report the same together with his findings of fact and conclusions of law. After hearings held before the Master, the latter made his report under date of May 23, 1949, wherein he found that the profits with which defendant Claughton was chargeable amounted to $308,417.50. On November 4, 1949, Hon. William Bondy, District Judge, made his memorandum decision herein confirming the report of the Master. Judgment was filed on November 29, 1949.

It was not disputed that defendant's total transactions in the stock of the railroad company, including those in which losses were incurred, resulted in an over-all loss to defendant. Defendant introduced proof before the Master indicating that such loss amounted to $401,627.42 (R. 29-30, 37).

The judgment of the District Court was unanimously affirmed by the United States Court of Appeals for the

Second Circuit (Hons. Learned Hand, Augustus N. Hand and Thomas W. Swan, Circuit Judges; opinion by Hon. Learned Hand).

The United States by reason of the constitutional questions raised was permitted to intervene, pursuant to 28 U. S. C. A. § 2403. The Securities and Exchange Commission was permitted to file a brief, *amicus curiae,* in the Court of Appeals by permission of said Court granted upon application of the Commission.

Basis of Jurisdiction

It is respectfully submitted that this Court has jurisdiction, upon appeal, to review the judgment or decree herein in question for the following reasons:

(a) The statutory provision which is believed to sustain the jurisdiction of this Court is 28 U. S. C. A. § 1254(1).

(b) There are involved herein the construction and constitutional validity of statutes of the United States particularly Section 16(b) of the Securities Exchange Act of 1934, 15 U. S. C. A. § 78p(b) and Section 27 of the Securities Exchange Act of 1934, 15 U. S. C. A. § 78aa.

(c) The date of the decree of the United States Court of Appeals for the Second Circuit sought to be reviewed herein is February 6, 1951.

The Questions Presented

The questions presented are as follows:

I

With Respect to Construction

(a) Whether, within the rule established by Section 27 of the Securities Exchange Act of 1934, the venue of the action was properly laid in the Southern District of New York and whether the District Court of that District acquired jurisdiction of the action.

(b) What did the Congress intend by the use of the expression "profit realized" in Section 16(b) of the Securities Exchange Act of 1934? Was it the actual profit as determined in the computation of income taxes—by comparing sales and purchases or purchases and sales of the identical stock, and in the event of failure to identify, by resorting to the "first in—first out" formula? Or was it the so-called "profit" arrived at by matching purchases at the lowest prices with sales at the highest prices, or vice versa?

(c) How is the six-month period provided in Section 16(b) of the Act to be applied to trading periods in excess of six months—in the instant case almost three years? Is it intended, for example, that we are to look six months before and six months after a sale for the purchase at the lowest price or for three months before and three months after a sale? Does not six months before and six months after the sale create two six-month periods for the matching of sales and purchases or a total period of one year, and does not such a result do violence to the statute (Section 16(b)) which speaks of " * * * any profit realized * * * within any period of less than six months * * *?"

II

With Respect to Constitutionality

(d) Does Section 16(b) of the Act contravene the Fifth Amendment to the Constitution of the United States, providing, in part, that "no person * * * shall be * * * deprived of * * * property without due process of law", in that

1. it appropriates the property of the dealer in securities without proof of bad faith, illegality, over-reaching or other unconscionable act;

2. it sets up no standard for the determination of the right to the taking of the dealer's profits, but arbitrarily declares that the same shall be the property of the issuer;

3. in furtherance of the object of the Act to prevent the abuse of information available to large stockholders, it does not permit resort to process for the determination of whether in truth and in fact there has been such abuse;

4. it arbitrarily confiscates the profits of the holder of more than ten per cent of any class of equity security without regard to whether such ownership amounts to control of the corporation, or whether such ownership may be solely of non-voting stock, or whether the beneficial owner was in a position to or did obtain inside information;

5. it creates a conclusive presumption of wrongdoing;

6. assuming Section 16(b) to be constitutional as applied to directors and officers of a corporation, the same reasoning would not be valid in the case of a stockholder having a ten per cent interest or even a greater percentage because the latter does

not necessarily have access to the secret information the threat of misuse of which furnished the basis for the statute?

(e) Does Section 16(b) of the Act violate Section 8 of Article I, Clause 18 of the Constitution of the United States vesting in the Congress the power to make all laws necessary and proper to carry into effect the powers set forth in said Section 8, Article I, and is it opposed to Section 1 of Article I of the Constitution of the United States vesting all legislative powers in the Congress, in that

1. it delegates undefined authority to the Securities and Exchange Commission to grant exemption;

2. it constitutes an unauthorized delegation of legislative powers?

(f) Is Section 16(b) of the Act violative of Clause 3 of Section 8 of Article I of the Constitution of the United States, giving the Congress power to regulate interstate commerce, in that

1. it applies to profits taken wholly within a state on orders placed therein?

(g) Does Section 16(b) of the Act contravene Sections 1 and 2 of Article III of the Constitution of the United States, which provide for the vesting of judicial power in the Courts, in that

1. it makes a judicial determination and deprives the Courts of the power to make a determination of the question whether inside information has been acquired or unfairly used for the purpose of making a profit?

(h) Does Section 27 of the Securities Exchange Act of 1934 as construed by the Courts below which provides that process "may be served in any other district of which

the defendant is an inhabitant or wherever the defendant may be found", contravene Section 2 of Article IV of the Constitution of the United States providing that citizens of each state shall be entitled to all privileges and immunities of citizens in the several states and does it not also violate the Fifth Amendment to the Constitution of the United States, in that

1. in permitting all such actions to be brought in the District where such stock transactions are effected, and since substantially all of said transactions are consummated on the New York Stock Exchange, those who reside in New York are specially favored over those residing elsewhere, the defense of such actions being rendered more expensive and burdensome for those residing or having a place of business outside of New York?

Reasons for the Allowance of the Writ—Importance of the Questions Presented

This application embraces important questions of federal law and issues of substance, which, it is respectfully submitted, should be passed upon and finally settled by this Court. Among such matters are the following:

1. The construction and constitutionality of Section 27 of the Act upon which the plaintiffs rely in support of the venue of the action and the jurisdiction of the United States District Court for the Southern District of New York, as applied to the facts and circumstances in the instant case.

2. The method of applying the six-month rule in Section 16(b) of the Act to trading periods extending over periods in excess of six months.

3. The application of Section 16(b) to stockholders ("beneficial owners") who are not officers or directors, and the constitutionality of Section 16(b) in its general

effect and insofar as it concerns those who are "beneficial owners" solely and who are not officers or directors.

4. The process to be followed in calculating "profit realized"—as between that of matching highest sale prices with lowest purchase prices (or vice versa) without regard to the identity of the stock certificates thus constituting a fictitious profit—and that which adopts the income tax rule resulting in the ascertainment of the profit realized in the true and literal sense of those words.

It is believed that the matters and issues above enumerated are of such substantial moment from the standpoints of legality and practical effect as to warrant the intervention of this Court for their final consideration and settlement. It is respectfully submitted that these matters and issues are within the contemplation of Rule 38, subdivisions 5(a) and 5(b), of the Rules of this Court.

That the legal questions hereinabove adverted to are vital in their consequences and far reaching in their effect and influence seems to petitioner to be without doubt. The statutes under consideration impinge upon, control and limit activities in transactions affecting equity securities of numerous corporations whose stock is registered on national exchanges. How far is it within the power of the Congress to go in supervising such activities? How far did Congress intend to go in carrying out its declared purposes? To what extent did the Congress desire to appropriate for the benefit of the corporation the avails of transactions when it spoke of "profit realized"? How far could Congress proceed without trespassing upon constitutional rights and privileges?

How far the effects of the determinations of the Courts below have carried is evident from the fact that the defendant in the instant case has been held liable for alleged profits—computed as outlined above—in a sum exceeding $308,000.00. In contrast, the defendant adduced proof to

the effect that his total transactions in the stock of the corporation during the period covered by the action resulted in an over-all loss to him of over $400,000.00. The learned Master, in his report, referred to the statute as being "somewhat harsh and severe" (R. 53). Did the Congress desire to stretch harshness and severity beyond capturing the actual profits? The plain wording of the statute coupled with its legislative history emphatically controverts the existence of such a desire; all that the Congress apparently was after were the real and actual profits. Circuit Judge Learned Hand, in his opinion, in speaking of the effects of Section 16(b), says (R. 90):

> "The crushing liabilities which Section 16(b) may impose are apparent from this action in which judgment was for over $300,000; * * *."

It can hardly be gainsaid that the controversy at hand poses question of substantial importance.

WHEREFORE, your petitioner prays that a Writ of Certiorari issue under the seal of this Court, directed to the United States Court of Appeals for the Second Circuit, commanding said Court to certify and send to this Court a transcript of the record and of the proceedings of the said United States Court of Appeals for the Second Circuit, had in this case, to the end that this cause may be reviewed and determined by this Court, as provided by the statutes of the United States; and that the decree herein of said United States Court of Appeals for the Second Circuit be reviewed by this Court; and for such other and further relief as to this Court may seem proper.

Respectfully submitted,

HENRY WARD BEER,
Counsel for Petitioner.

Supreme Court of the United States

October Term 1950

No.

EDWARD N. CLAUGHTON,

Petitioner,

against

STELLA GRATZ, suing as a stockholder in the name and in behalf of MISSOURI-KANSAS-TEXAS RAILROAD COMPANY, MISSOURI-KANSAS-TEXAS RAILROAD COMPANY and UNITED STATES OF AMERICA,

Respondents.

PETITIONER'S BRIEF

Edward N. Claughton, the defendant-appellant herein, applies for a Writ of Certiorari to the United States Supreme Court to review a decree of the United States Court of Appeals for the Second Circuit (Hons. Learned Hand, Augustus N. Hand and Edward Swan, Circuit Judges) affirming a judgment of the United States District Court for the Southern District of New York (Bondy, District Judge), which, in an action brought under Section 16(b) of the Securities Exchange Act of 1934, 15 U. S. C. A. § 78p(b), adjudged that the plaintiff-appellee Missouri-Kansas-Texas Railroad Company recover from defendant the sum of $308,417.50 plus costs as taxed.

Opinions of the Court Below

There was an opinion in the United States Court of Appeals for the Second Circuit (per Hon. Learned Hand, Circuit Judge), which has not yet been reported. It will be found in the Record at page 82.

Alexander Pfeiffer, Esq., who was appointed Master by the District Court to take evidence on the sole issue of damages, filed his report which was confirmed by the District Court (Bondy, D. J.) in a memorandum decision. The Master's report will be found in the Record at pages 42-60, inclusive. It was not the subject of an official report.

Basis of Jurisdiction

The basis of jurisdiction is set forth in the petition preceding the within brief at page 5.

The Statutes

The explanation of the judgment is to be found in the supposed command of the statutes—Sections 16(b) and 27 of the Securities Exchange Act of 1934—the relevant portions of which are quoted at pages 15 and 19, *infra*, respectively.

Statement of the Case

This action was instituted on April 4, 1946, by Stella Gratz, as plaintiff, against Edward N. Claughton and Missouri-Kansas-Texas Railroad Company, as defendants, pursuant to Section 16(b) of the Securities Exchange Act of 1934, 15 U. S. C. A. § 78p(b), to recover from the said Edward N. Claughton profits allegedly realized by him from dealings in the corporation's securities within periods of less than six months.

On April 8, 1948, an order was made herein naming Missouri-Kansas-Texas Railroad Company as a party plain-

tiff instead of a party defendant and amending the title of the action accordingly.

The Securities Exchange Act of 1934 (48 Stat. 881, 15 U. S. C. A. § 78) regulates exchanges and transactions in securities on exchanges or in over-the-counter markets. It provides for the registration with the Securities and Exchange Commission of exchanges and of securities traded on exchanges. It makes certain transactions in securities unlawful. It attaches civil liability to, but does not make unlawful, certain other transactions in securities.

Section 16(a) of the Act requires every person who is directly or indirectly the beneficial owner of more than 10% of any equity security (other than an exempted security) registered on a national securities exchange, or who is a director or an officer of the issuer of such security, to file a statement with the exchange and the Securities and Exchange Commission of the amount of equity securities of which he is the owner, and within ten days after the close of each current month thereafter to file another statement indicating his ownership and such changes therein as have occurred during such current month.

Section 16(b) of the Act upon which the instant action is predicated, provides in part:

> "For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering

into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months."

Particularly exempted from the provisions of the statute are (1) transactions where the beneficial owner was not such both at the time of the purchase and at the time of the sale; (2) acquisition of securities in good faith in connection with a debt previously contracted and (3) such securities as the Securities and Exchange Commission may, by rule or regulation, exempt as not comprehended within the purpose of the section.

Plaintiffs rested venue in the Southern District and jurisdiction of the United States District Court for the Southern District of New York upon Section 27 of the Securities Exchange Act of 1934 as construed by plaintiffs. The relevant portions of said section are quoted under Point I of this brief.

Defendant Edward N. Claughton was sued herein as such alleged "beneficial owner". No claim was made that he was an officer or director of the railroad company, and the fact is that he was not an officer or director.

The transactions for which defendant was held accountable extended over a period from December 18, 1944 to December 3, 1947.

Through various notices of motion of defendant Edward N. Claughton served during the period from April 1946 to January 1947 and consolidated into one motion, said defendant moved to dismiss the action for failure to state a claim upon which relief could be granted, improper venue, lack of jurisdiction, and upon constitutional grounds. Said motion was denied by order dated April 15, 1947.

On May 19, 1947, an order was made upon motion of plaintiff Stella Gratz granting summary judgment, pursuant to Rule 56 of the Rules of Civil Procedure, in favor

of said plaintiff against defendant Edward N. Claughton, and directing that the cause be referred to Alexander Pfeiffer, Esq., as Master, to take evidence on the sole issue of damages, and to report the same together with his findings of fact and conclusions of law. After hearings held before the Master, the latter made his report under date of May 23, 1949, wherein he found that the profits with which defendant Claughton was chargeable amounted to $308,417.50. On November 4, 1949, Hon. William Bondy, District Judge, made his memorandum decision herein confirming the report of the Master. Judgment was filed on November 29, 1949.

It was not disputed that defendant's total transactions in the stock of the railroad company, including those in which losses were incurred, resulted in an over-all loss to defendant. Defendant introduced proof before the Master indicating that such loss amounted to $401,627.42 (R. 29-30, 37).

Specification of Errors

It is respectfully submitted that the Courts below erred in the following respects:

1. In holding that the defendant committed wrongful acts in New York by his short-swing stock transactions in face of the facts that Section 16(b) of the Act does not make such transactions unlawful and that the sole liability which it imposes is that of accounting for the profits realized.

2. In holding that the six-month rule in Section 16(b) of the Act permits going back six months and forward six months from a sale in the search for a purchase at the lowest price in order to compute profits, and in rejecting defendant's contention that such search be limited to three months prior and three months subsequent to a sale.

3. In arriving at profits by matching highest sales prices with lowest purchase prices of stocks represented by certificates that have no relationship or identity with each other, and rejecting defendant's contention that in using the expression "profit realized" the Congress had in mind real and actual profits determined in accordance with the rule adhered to in the operation of the Income Tax Law.

4. In construing Sections 16(b) and 27 of the Act without due regard to their plain meanings as said meanings are further illuminated by the legislative history culminating in said enactments, and in reaching the conclusion that the Congress in its attempt to nullify whatever benefit might accrue from short-swing dealings in stock by a "beneficial owner" intended to confiscate more than the actual profits accruing from such transactions.

5. In overlooking established principles of constitutional law by rejecting the considerations urged by defendant in opposition to the constitutionality of Sections 16(b) and 27.

Summary of Defendant's Arguments

Defendant appealed from said judgment and based said appeal upon the subjoined main points in which are reflected the errors upon which defendant relied for the relief herein sought.

1. The venue of the action was not properly laid in the Southern District of New York, and the District Court of that District was without jurisdiction in the premises.

2. A. The District Court erroneously applied the six months rule in Section 16(b) of the Securities Exchange Act of 1934 to the facts and circumstances in this instant case, in arriving at a determination of the amount of damages.

B. The six months rule as applied by defendant under which the recoverable profits were found to amount to $117,137.71 should have been adopted by the Court as fixing the maximum profits recoverable from defendant and as furnishing the "more reasonable rule" for which this Court left the door open in the case of *Smolowe* v. *Delendo*, 136 F. (2d) 231 (C. C. A. 2, 1943), cert. den. *Delendo Corp.* v. *Smolowe*, 320 U. S. 751.

3. Section 16(b) contemplated that the term "profit realized" should be the actual profit arising from the purchase and sale or sale and purchase of the same class of stock, within the definition of the Income Tax Law, and not a fictitious profit calculated upon the lowest price in-highest price out.

4. Sections 16(b) and 27 of the Securities Exchange Act of 1934 are unconstitutional.

We shall consider the foregoing grounds of appeal in the order named.

POINT I

The venue of the action was not properly laid in the Southern District of New York, and the District Court of that District was without jurisdiction in the premises.

Jurisdiction and venue of the instant action are based upon and controlled by Section 27 of the Securities Exchange Act of 1934, 15 U. S. C. A. Section 78aa, which provides in pertinent part as follows:

> "The district courts of the United States • • • shall have exclusive jurisdiction of violations of this chapter or the rules and regulations thereunder, and of all suits in equity and actions at law brought to enforce any liability or duty created by this chapter

> or the rules and regulations thereunder. Any criminal proceeding may be brought in the district wherein any act or transaction constituting the violation occurred. Any suit or action to enforce any liability or duty created by this chapter or rules and regulations thereunder, or to enjoin any violation of such chapter or rules and regulations, may be brought in any such district or in the district wherein the defendant is found or is an inhabitant or transacts business, and process in such cases may be served in any other district of which the defendant is an inhabitant or wherever the defendant may be found."

Section 16(b) does not make unlawful the alleged purchases and sales on the New York Stock Exchange, or the realization of profit from such transactions; all that it does is to create a civil liability to the issuer. As stated in *Smolowe* v. *Delendo Corporation,* 46 F. Supp. 758, 764, (aff'd 136 F. (2d) 231, cert. den. *Delendo Corp.* v. *Smolowe,* 320 U. S. 751):

> "It does not prohibit such transactions. It merely removes the profit of the individual."

The summons and complaint were served on defendant Edward N. Claughton in Florida.

Defendant Edward N. Claughton was not a resident of New York; he was a resident and inhabitant of Florida, and he did not transact business in New York (Item "6", p. 1 of record not printed). The Missouri-Kansas-Texas Railroad Company is a Missouri corporation and its principal place of business was located in St. Louis, Missouri (Item "2", p. of record not printed). Plaintiff Stella Gratz was a resident of New York (Item "2", p. 1 of record not printed). There was no dispute as to the foregoing. Nor is there any dispute as to the fact that

the situations above referred to prevailed throughout the period embraced in this action.

The question arises: Was the venue of the action properly laid in the Southern District of New York and did the District Court of that district acquire jurisdiction by the service of the summons and complaint in Florida? That both of the questions posed must be answered in the negative conclusively appears from the discussion that follows:

A. The words, "Act or transaction constituting the violation" obviously refer to an unlawful act or transaction; there is entirely absent from this case any allegation or proof of any unlawful act or transaction within the Southern District of New York or elsewhere.

By the expression "act or transaction constituting the violation" in Section 27 of the Act, Congress obviously meant those acts or transactions prohibited by the statute and expressly made unlawful by said Act. Among such acts or transactions enumerated in the Act are the following:

Section 9, which prohibits the manipulation of security prices; Section 10, which outlaws the use of deceptive devices; Section 14, which makes it unlawful for any person to solicit proxies in contravention of the rules and regulation of the Commission; Section 16(c), which makes it unlawful for the beneficial owner of more than 10 per cent of any class of unexempted equity security, or for a director or officer, to sell such security if he does not own it, or if owning it, does not deliver it against its sale within a prescribed period; Section 20(b), which makes it unlawful for one person to do an unlawful act through another; Section 20(c), which makes it unlawful for any director or officer or security owner to delay or obstruct, without just cause, the making or filing of any required report, document or information.

There are additional acts made unlawful by the Act. Nowhere, however, is the purchase and sale of stock or the making of a profit thereon by a 10 per cent equity stockholder made unlawful.

Some of the unlawful acts are also made the basis of civil liability, as, for example: in subdivision (e) of Section 9 (Prohibition against "manipulation of security prices"). At the same time, the Act creates civil liability but does not make unlawful the transaction giving rise to civil liability. Such a transaction is that found and dealt with in Section 16(b) upon which the instant action is predicated.

A "suit or action to enforce any liability or duty created by this chapter", may, therefore, be based either on a transaction made unlawful by the Act or on a transaction not made unlawful.

The plain import of Section 27 is as follows:

(I) If the conduct of a defendant is unlawful (that is, constitutes a "violation") and also gives rise to civil liability, an action to enforce such liability may be brought either in the district where the unlawful act took place or in the district wherein the defendant "is found or is an inhabitant or transacts business".

(II) If the conduct of a defendant is not unlawful (that is, does not constitute a "violation" which would subject him to criminal prosecution) but does give rise to civil liability, then an action to enforce such liability may be brought only in the district where the defendant "is found or is an inhabitant or transacts business".

The case at bar is brought to enforce a civil liability created by Section 16(b) of the Act. That section does not prohibit any conduct nor make any conduct unlawful; it merely provides that an issuer may recover profits made by a beneficial owner, director or officer on stock purchases and sales effected under specified circumstances.

It does not appear unreasonable that Congress saw fit to provide a somewhat broader venue for actions based on criminal conduct than for other actions. The venue provided for civil suits to recover short swing profits is adequate for the purposes sought to be accomplished by the Act. These suits may be brought wherever the defendant is "found or is an inhabitant or transacts business". This is at least as broad as the venue provided for civil suits based on criminal offenses under the anti-trust laws (Title 15 U. S. C. A. § 15) and far broader than that governing the great mass of civil litigation in Federal Courts based on diversity of citizenship (Title 28, U. S. C. A., § 1391). Congress undoubtedly also had in mind the great burden to which litigants not charged with unlawful conduct would be subjected if they were compelled to litigate their civil liability thousands of miles from their records, their businesses and their residences.

It is not by accident or inadvertence that Congress limited the effect of Section 16(b) to the creation of a civil liability. The Bill as introduced S. 2693, H.R. 7852; 78 Cong. Rec. Part 2, p. 2265) contained this provision:

> "It shall be *unlawful* for any director, officer or owner of securities, owning as of record and/or beneficially more than 5 per centum of any class of stock of any issuer, any security which is registered on a national securities exchange:
>
> (1) To purchase any such registered security with the intention or expectation of selling the same security within six months; and any profit made by such person on any transaction in such a registered security extending over a period of less than six months shall inure to and be recoverable by the issuer. * * * " (Italics added.)

And as to venue provided:

> "Any such criminal proceeding may be brought either in the district wherein the exchange involved is operated, or in the district wherein a transaction violating such provision was consummated, or in the district wherein an act or agreement to act constituting such violation was effected. Any such civil suit may be brought in any such district or in the district wherein the defendant is found or is an inhabitant or transacts business * * *."

Congress deliberately changed the text of the Bill so that, as enacted, Section 16(b) does *not* make any purchases and sales unlawful but subjects to a civil liability the persons described therein who purchase and sell under the circumstances stated. At the same time, Congress changed the venue provisions to those now contained in Section 27, as quoted hereinabove.

This action could not be brought in the Southern District of New York, but could only have been brought, as is required by Section 27 of the Act, in "the district wherein the defendant is found or is an inhabitant or transacts business".

B. Even if the words, "act or transaction constituting the violation" be taken as referring to an "act or transaction" giving rise merely to a civil liability, there is no allegation or proof of any such act or transaction within the Southern District of New York.

The fact that the New York Stock Exchange is located in the Southern District of New York is of no significance. The Bill as introduced would have permitted a civil suit to be brought in the district "wherein the exchange involved is located", but Congres struck out this provision before enactment.

The gravamen of the complaint is the failure of defendant to pay over to the railroad company profits alleged to have been realized by him from purchases and sales and/or sales and purchases of stock within a period of less than six months.

The following observations are beyond contradiction:

1. Neither the purchases nor the sales give rise to a cause of action.
2. The realization of profit does not give rise to a cause of action.
3. Defendant did not violate any law in carrying on the stock transactions embraced in the action.
4. Defendant did not violate any law if he realized a profit on his said stock transactions.
5. The sole claim out of which the action arises is defendant's failure to pay over the alleged profits.
6. The alleged profits were payable to the corporation, if at all, in St. Louis, the location of the corporation's principal place of business, or in Miami, Florida, where defendant resided, but not in New York.

Inasmuch as the defendant was not found in New York, is not an inhabitant of New York and does not transact business in New York, it is obvious that the Court below did not acquire jurisdiction over him. The defendant did nothing in New York that was in violation of Section 16(b).

If Congress had intended to lay venue in any district in which a purchase and sale occurs, it would undoubtedly have so provided, as it did in *Section 22(a) of the Securities Act of 1933, 15 U. S. C. A., Section 77v(a)*, from which we quote as follows:

> "(a) The district courts of the United States, the United States courts of any Territory, and the

district court of the United States for the District of Columbia shall have jurisdiction of offenses and violations under this title and under the rules and regulations promulgated by the Commission in respect thereto, and, concurrent with State and Territorial courts, of all suits in equity and actions at law brought to enforce any liability or duty created by this sub-chapter. Any such suit or action may be brought in the district wherein the defendant is found or is an inhabitant or transacts business, *or in the district where the sale took place,* if the defendant participated therein, and process in such cases may be served in any other district of which the defendant is an inhabitant or wherever the defendant may be found. * * * " (Italics added.)

The circumstances of improper venue and absence of jurisdiction made mandatory the dismissal of the action. The learned Courts below erred in denying dismissal upon those grounds.

POINT II

A. The Courts below erroneously applied the six months rule in Section 16(b) of the Securities Exchange Act of 1934 to the facts and circumstances in the instant case, in arriving at a determination of the amount of damages.

B. The six months rule as applied by defendant under which the recoverable profits were found to amount to $117,137.71 should have been adopted by the Courts below as fixing the maximum profits recoverable from defendant and as furnishing the "more reasonable rule" for which this Court of Appeals left the door open in the case of *Smolowe* v. *Delendo*, 136 F. (2d) 231.

The discussion under this point is limited to the time factor contained in Section 16(b). The additional steps involved in arriving at the amount of profits are taken up under Point III.

A. The six months rule as applied by the District Court.

The Master found that the profits for which defendant is accountable to plaintiff, Missouri-Kansas-Texas Railroad Company, amounted to $308,417.50 (R. 56), and the Court below approved such finding as well as the method of computation which resulted in that figure (R. 60). Plaintiffs claimed and the Courts also found that such method of calculation finds its support in *Smolowe* v. *Delendo*, 46 F. Supp. 758, 136 F. (2d) 231, cert. den. *Delendo Corp.* v. *Smolowe* (1943), 320 U. S. 751 (R. 53, 54).

In considering the applicability of the rule in the *Smolowe* case, there should be borne in mind one highly

distinguishing feature. It lies in the fact that in the *Smolowe* case a single period of less than six months was involved—from December 1, 1939 to June 1, 1940 (46 Fed. Supp. 758, 762)—while in the case at bar, we have to deal with a trading period covering almost three years—from December 18, 1944 to December 3, 1947.

Furthermore, a reading of the *Smolowe* opinions in the District Court (46 Fed. Supp. 758) and in the Court of Appeals (136 F. (2d) 231) strongly suggests that the subject of quantum of damages did not lend itself to final and decisive solution. Certain it is that the selection of the formula adopted for calculating profits within the purview of the statute was not considered to be inflexible. In the District Court, losses were at first taken into consideration but were subsequently cancelled in a supplemental opinion (46 Fed. Supp. 766). In the Court of Appeals the rule of damages is expresed as follows (136 Fed. (2d) 231, 239):

> "The only rule whereby all possible profits can be surely recovered is that of the lowest price in, highest price out—within six months—as applied by the District Court."

The above statement is then followed with the declaration,

> "We affirm it here, defendants having failed to suggest another more reasonable rule."

The Master in his report defined the method of computation in the following language (R. 54):

> "• • • upon the basis of highest price out and lowest price in during the period of his (Claughton's) trading, as to purchases and sales and sales and purchases, after Claughton had become such a 10% stockholder, within any period of less than six months, treating such transactions on a six months basis retrospectively and prospectively."

However, this is not the formula for the ascertainment of profits envisaged by the statute as being applicable to periods longer than six months in duration. The determinative words of the statute are:

> "* * * any profit realized by him from any purchase and sale, or any sale and purchase of any equity security * * * within any period of less than six months * * *."

Thus, by the method of calculation whereby profits in the sum of $308,417.50 have been found, not a period of less than six months, but rather a period short of one year is set up within which the matching of highest sales with lowest purchases, or lowest purchases with highest sales, takes place. Under plaintiffs' formula, if the highest sale took place on July 1st, one can go back as far as January 2nd preceding and forward as far as December 31st following, in order to match the highest sales price with the lowest purchase price. The result is that there is a spread of two-six month periods or just short of one year within which the search for the counter-balancing transaction—a sale with a purchase or a purchase with a sale—may be made. That is not the "short swing" transaction contemplated by the statute when it refers to transactions "within any period of less than six months".

B. The six months rule as contended for by defendant.

As opposed to the time formula advocated by plaintiffs, defendant submitted the calculation found in Defendant's Exhibit "AA" (as to common stock transactions) and Defendant's Exhibit "BB" (as to preferred stock transactions) under which the profit amounts to $117,137.71, as the maximum amount for which defendant may be held liable within the letter and intent of the statute. By said calculations, the highest sales price is matched with the

lowest purchase price (or the lowest purchase price with the highest sales price), within three months before and three months after such sale (or purchase). Here the period that is established for matching sale and purchase prices is precisely within six months.

While applying the six months rule in that way, we have at the same time adhered to the additional guides formulated in the *Smolowe* case for the determination of profits, *i. e.*, purchases and sales have not been matched by identity of stock certificates, the "first in, first out" rule has not been utilized, an average sale and purchase price has not been struck, and losses have not been deducted. For it was in an effort to fix the limits of defendant's liability that defendant concentrated upon the application of the six month rule to trading periods in excess of six months and adopted for such purpose only, the additional guides advanced by plaintiffs without, however, conceding their validity.

In constructing the formula which we asked the Master and the Courts below to accept as measuring the maximum amount for which the defendant could be held liable, we deferred to plaintiffs' procedure in order to cut down the area of dispute on the issue of damages that was submitted to the Master. However, that was not to say that defendant acquiesced in the acceptance of all of the other component parts of plaintiffs' integrated process for determining the question of profit.

In Point III of this brief, defendant enlarges upon his objections to the rule enunciated in the *Smolowe* case for the arithmetical computation of profits—aside from the six months rule—based as it is upon the theory of matching highest sales prices with lowest purchase prices.

The purport of the within Point II is to demonstrate to the Court that even if the arithmetical rule supported by

plaintiffs were observed, the correct application of the six months period to plaintiffs' mode of arithmetical computation would limit profits and therefore plaintiffs' recovery to the sum of $117,137.71.

POINT III

Section 16(b) contemplates that the term "Profit Realized" should be the actual profit arising from the purchase and sale or sale and purchase of the same class of stock, within the definition of the Income Tax Law, and not a fictitious profit calculated upon the lowest price in-highest price out.

We come now to the discussion regarding that part of the complete formula for the determination of profits—apart from the six months rule—having to do with arithmetical computation.

As shown above, plaintiffs' procedure for the ascertainment of the profits that inure to the corporation consists in matching highest sales prices with lowest purchase prices and lowest purchase prices with highest sales prices. In this process no attention is paid as to whether or not the particular items paired embrace the same stock certificates.

Defendant strongly challenges this procedure and pleads for the income tax rule for the computation of profits.

The income tax rule is expressed as follows (U. S. Treasury Reg. 103, Section 19.22 (a)-8):

> "If shares of stock in a corporation are sold from lots purchased at different dates or at different prices and the identity of the lots cannot be determined, the stock sold shall be charged to the earliest purchases of such stock."

In other words, under income tax practice we first look to the identity of stock certificates and if certificates cannot be identified, the presumption of "first-in, first-out" is resorted to.

It is respectfully submitted that the income tax rule is in accord with the realities, sound reason and the history of the legislation which finally culminated in the enactment of Section 16(b).

The significant and controlling words of the statute are:

> "* * * any profit realized by him from any purchase and sale, or any sale or purchase, of any equity security."

A. It is a recognized canon of construction that words must be taken in their ordinary and commonly accepted sense. *Caminetti* v. *United States*, 242 U. S. 470; *Cooper-Snell* v. *New York*, 230 N. Y. 249.

Funk & Wagnall's New Standard Dictionary (1941) defines "profit" as:

> "That part of the price received for goods which exceeds the price paid for them, inclusive of all secondary expenses, as storing, handling, marketing, etc, or of producing, etc."

The point need not be belabored that as between the "lowest in-highest out" rule that disregards the identity of stock certificates, and the income tax rule that first matches off the same stock transactions against each other and if that cannot be done, then uses the "first-in, first-out" process—that the income tax rule constitutes at least the more proximate approach to the ordinary and commonly accepted meaning of the word "profit".

"Profit" comprehends a debit and a credit with the same transaction and if that cannot be accomplished, then

resort to the "first in—first out" formula, and not the matching of unrelated transactions.

The figure resulting from the matching of highest sales prices with lowest purchase prices of stocks represented by certificates that have no relationship to or identity with each other is not "profit" as the word is generally understood. A result thus obtained is not a real profit, but a fictitious profit. Such a result is entirely foreign to "profit realized".

B. The crucial question is, What did the Congress have in mind by the word "profit", or better still by the expression, "any profit realized"?

It is also a cardinal principal governing the construction of statutes that the paramount consideration of the Courts is to ascertain and give effect to the intention of the Legislature (*Vait* v. *Railroad Co.*, 147 N. Y. 377, 381), *Matter of Meyer*, 209 N. Y. 386, 390).

As stated by the Appellate Division, of New York, 1st Dep't, in *Metropolitan Life* v. *Durkin*, 94 N. Y. S. (2d) 865, 869:

> "The spirit and purpose of the law and the objects to be accomplished must be considered. The legislative intent is the great and controlling principle (*People* v. *Ryan*, 274 N. Y. 149, 152)".

The drafts of the statute (S. 2693, H. R. 7852; 78 Cong. Rec. Part 2, p. 2265) of which portions were considered under Point I, read in part as follows:

> "It shall be unlawful for any director, officer or owner of securities, owning as of record and/or beneficially more than 5 per centum of any class of stock of any issuer, any security which is registered on a national securities exchange:

> (1) To purchase any such registered security with the intention or expectation of selling the same security within six months; and any profit made by such person on any transactions in such a registered security extending over a period of less than six months shall inure to and be recoverable by the issuer * * * "
>
> "For the purposes of this subsection the profit shall be calculated on the sale or sales by such person of such security *made at the highest price or prices and on the purchase or purchases made by such person of such security at the lowest price or prices* during the six months' period, *irrespective of the certificates for such security received or delivered by such person during such period.*" (Italics added.)

At the Senate Committee hearings referred to by the Court of Appeals in its opinion (136 F. (2d) at page 237), the following colloquy took place between Senator Barkley (now Vice-President Barkley) and Mr. Corcoran, draftsman of the proposed enactment with reference to the phraseology of the draft.

Senator Barkley: "All these transactions are a matter of record. It seems to me the simple way would be to charge him with the actual profit."

The foregoing statement is a clear indication of the fact that Senator Barkley was of the opinion that the computation should be based upon the actual profit from each transaction.

Mr. Corcoran's reply to the above statement was:

> "It is the same provision you have in the income tax law. Unless you can prove the actual relationship between the certificates, you take the highest price sold and the lowest price bought." (See Hearings before Committee on Banking and Currency, pp. 6558-6559.)

The income tax rule provides for "first in-first out" and not "highest price sold and lowest price bought" as Mr. Corcoran erroneously declared. However, both the remarks of Senator Barkley and Mr. Corcoran are of vital significance as reflecting that the idea entertained by them was that the income tax rule was to be applied. Senator Barkley spoke of the "actual profit" appearing from transactions that "are a matter of record". Mr. Corcoran said in substance that the profit provisions in the draft conform to the income tax law, and although he incorrectly associates with it the principle of "highest price sold against lowest price bought", he prefaces that portion of his statement with the words, "unless you can prove the relationship between the certificates," which amounts to the approval and confirmation of the income tax rule.

There can be no question over the fact that the same purposes as to the application of income tax standards actuated the Congress when it came to pass Section 16(b).

That this is so is also apparent from the following:

(1) The requirement that profits be calculated on the basis of highest sales prices and lowest purchase prices as contained in the draft, was entirely eliminated from Section 16(b).

(2) Also deliberately excised, when Congress came to pass Section 16(b), was the following clause as contained in the draft:

"* * * irrespective of the certificates for such security received or delivered by such person during such period."

(3) In place of the phraseology which the Congress rejected, it substituted the words:

"* * * any profit realized by him from any purchase and sale, or any sale and purchase * * *."

The word "profit" coupled with the word "realized" form the expression "profit realized" that was written into the statute as finally enacted, and the deliberate omission of the provisions of the draft to which attention has been called, constitute a firm, emphatic and clear Congressional pronouncement to the effect that what the Congress desired to pass on to the corporation should be the actual profit with reference to the purchase and sale, or sale and purchase of the identical stock, or if identification is not possible then under the "first in, first out" rule, within the conception and in accordance with the practice prevailing in the administration of the income tax law. The contrary holding goes counter to the express intention of the Congress to conform to established principles of procedure.

(4) The formula relied upon by plaintiffs is said to harmonize with the aim ascribed to the Congress to "squeeze all possible profits out of stock transactions" (136 F. (2d) at p. 239). However, it is respectfully submitted that the road to the accomplishment of that aim does not lie in resort to a method for the determination of purported profits which had been unmistakably rejected and for which different language had been expressly substituted to accord with what the Congress desired to accomplish and with the means that the Congress intended to employ in reaching the end it had in mind.

(5) Even if we did not have these positive signposts to the intent of the Congress, even if there were absent from this case the historical background heretofore outlined, the very fact that the Congress failed to define a different method for calculating profits speaks eloquently for the conclusion that it did not have the remotest idea of departing to a degree so fundamental and so unprecedented from

the meaning usually and customarily associated with the word "profit" and especially with the term "profit realized". It is fair to assume that if Congress ever conceived the idea of deviating from the usual norm in measuring the quantum of profits firmly grounded in years of well-tried experience in the administration of the income tax law, it would have made plain such intent in clear and unequivocal terms.

(6) In speaking of "* * * any profit realized * * * from any purchase and sale, or any sale and purchase * * * within any period of less than six months * * *" (Section 16(b)), it is to be presumed that the Congress was not entirely oblivious of losses that might be sustained during that period, and not having expressly declared itself to the contrary, the conclusion is reasonable and logical that losses were to be set off against gains realized during the same six month period.

(7) It is asserted that enforcement under the income tax rule would be nullified through the use by a larger stockholder of a reserve of stock accumulated by him. That contention, however, is answerable by the fact that whatever the correct rule as to computation of damages may be, it is only applicable to stock purchased and sold "within any period of less than six months" as prescribed by Section 16(b).

(8) Nor does the difficulty that is envisaged in preventing evasions in the observance of or compliance with the law offer a reason for the rejection of the income tax rule and the acceptance of a rule that had been deliberately repudiated.

The claim that problems may arise in the carrying out of the law, under the construction urged by

defendant, is answered by the satisfactory experience had in carrying out the corresponding provisions of the income tax law. The rule invoked by defendant has been found to be adequate in computing, and if need be, in ferretting out profits from which are determined income taxes payable to our Federal and State Governments in order to enable them properly to carry out their functions. It should be equally effective to determine and to locate, if required, profits that are required to be turned over to a corporation which has suffered no financial loss in the activities of one who trades in its securities. It is not to be supposed that the Congress is less solicitous in the operation of the income tax law than in the enforcement of Section 16(b).

POINT IV

Sections 16(b) and 27 of the Securities Exchange Act of 1934 are unconstitutional.

As to Section 16(b)

A. Section 16(b) of the Securities Exchange Act of 1934 (sec. (b) of par. 16 of the Act of June 6, 1934, 48 Stat. 896; 15 U. S. C. A. § 78 p. (b)) contravenes the Fifth Amendment to the Constitution of the United States which provides in part, that "no person * * * shall be * * * deprived of * * * property without due process of law", in the following particulars and respects:

(1) It is confiscatory in that it appropriates the property of the trader, to wit: the profits, for the benefit of the issuer without requiring proof of bad faith, illegality, over-reaching or other unconscionable act, taking said property by legislative fiat and not by legal process.

(2) It sets up no standard for the determination of the right to the taking of the trader's profits and appropriating the same for the issuer's benefits, but arbitrarily declares that the same shall be the property of the issuer.

(3) It is obviously the objective of the Act to prevent the abuse of information available to large stockholders in buying and selling stock based thereon, but no resort to process is permitted to make a determination whether there has been such abuse.

(4) It arbitrarily confiscates, for the benefit of the issuer, the profits of a holder of more than ten per centum of any class of equity stock under any of the following circumstances:

a. Without regard to whether such ownership amounts to control of the corporation.

b. Without regard to whether such ownership may be solely of non-voting equity stock.

c. Without regard to whether the beneficial owner was in a position to, or did obtain inside information, thus creating a conclusive presumption of wrong-doing and precluding the security holder from establishing his innocence from wrong-doing, and depriving him of his day in Court.

To presume that an act was done which was not done is erroneous. A law which creates a presumption that is arbitrary and that operates to deny a fair opportunity to repel it violates the due process clause. *Heiner* v. *Donnan*, 285 U. S. 312, 52 S. Ct. 358; *Schlesinger* v. *Wisconsin*, 270 U. S. 230, 46 S. Ct. 260; *Manley* v. *State of Georgia*, 279 U. S. 1, 49 S. Ct. 215.

d. Even assuming that Congress had the right to make an arbitrary percentage of stock ownership conclusive proof of the use of inside information, the low percentage fixed is arbitrary.

e. The fact that Congress included non-voting stock ownership as giving rise to presumption of the use of inside information in the earning of profits demonstrates that the standards imposed were arbitrary and capricious.

B. That Section 16(b) contravenes Section 8 of Article I, clause 18, of the Constitution of the United States vesting in the Congress of the United States the power to make all laws which shall be necessary and proper to carry into effect the powers enumerated in said Section 8, Article I, and is violative of Section 1, Article I, of the Constitution of the United States vesting all legislative powers in the congress in the following particulars and respects, to-wit:

(1) It attempts to delegate undefined authority to the Securities and Exchange Commission to grant exemptions to equity securities without setting forth in the Act the basis upon which such exemptions are to be made.

(2) It does not require uniformity in the classification or basis of such exemptions, but permits the Securities and Exchange Commission arbitrarily to grant such exemption and thereby prefer one person over another.

(3) It constitutes an authorized delegation of legislative power.

The correct principles of law relating to the extent to which legislature power may be delegated find ready application. *Panama Refining Co.* v. *Ryan,* 293 U. S. 388, 55 S. Ct. 241; *Schechter Corp.* v. *United States,* 295 U. S. 495,

55 S. Ct. 837; *Opp Cotton Mills* v. *Administrator*, 312 U. S. 126, 61 S. Ct. 524.

C. That under Section 8, Article I of the Constitution of the United States, Clause 3, giving Congress the power to regulate commerce among the several states, the power is not given to Congress to enact said Section 16(b) of the Securities Exchange Act of 1934 so as to apply to profits taken wholly within a state on orders placed therein, for the following reasons:

(1) The Act does not make the buying and selling unlawful, but merely appropriates the profits of such trading for the benefit of the issuer of the equity security and therefore it is the taking of the profit which it seeks to regulate and the complaint fails to show the interstate character of the transaction with respect to the taking of profits.

(2) That the transaction is complete whenever an order is delivered to the local brokerage office or agent to buy or sell and therefore is not a transaction in interstate commerce.

Schechter v. *United States*, 295 U. S. 495, 542, 543, 544, 548, 55 S. Ct. 837;
Broadnax v. *Missouri*, 219 U. S. 285, 31 S. Ct. 238.

D. That Section 16(b) contravenes Section 1 and 2 of Article III of the Constitution of the United States, which provide for the vesting of judicial power in the Courts, in the following particulars and respects, to-wit:

(1) It is a legislative attempt to make a judicial determination and deprives the Court of the power of determination of the question whether inside information has been unfairly used by such equity security holder for the purpose of making a profit and amounts to an unwarranted and unconstitutional invasion of the judicial power.

(2) It deprives the judiciary of the right to make a judicial determination of the question of intent in connection with the use of inside information by the trader and deprives the Court of the power to make the factual determination as to whether or not information was possessed by the person trading in such equity securities.

Congress is without authority to arrogate to itself judicial functions. *Kilbourne* v. *Thompson*, 103 U. S. 168.

As to Section 27

The following constitutional considerations respecting Section 27 of the Act become material only if the Court should overrule defendant's contentions under Point I as to the impropriety of venue and the invalidity of the service of the summons and complaint herein.

E. That the clause of Section 27 of the Securities Exchange Act of 1934 (Par. 27 of the Act of 6 June 1934, c. 404, 48 Stat. 902; 15 U. S. C. A., § 78aa) which provides that process in such cases may be served in any other district of which the defendant is an inhabitant or wherever the defendant may be found, contravenes Section 2 of Article IV of the Constitution of the United States providing that the citizens of each state shall be entitled to all privileges and immunities of citizens in the several states, and also contravenes the Fifth Amendment to the Constitution of the United States in the following respects:

If venue is permitted in New York because of the fact that the bulk of the stock transactions were effected on the New York Stock Exchange, in which substantially all of such securities in the United States are registered and trading transactions consummated, and suits thereunder are not required to be brought in the district of domicile of the trader or of his principal place of business, and if

process is permitted to be served in any district where the defendant is an inhabitant or where he is found, the said portion of the Act deprives this defendant and others similarly situated of due process and of equal protection of the law and equal privileges in that it makes the defense of such actions unreasonably expensive and inconvenient. The situation that plaintiffs' construction of Section 27 necessarily leads to may be summarized as follows:

(1) The actions may then be brought in a place that is far removed from the domicile or place of business of the defendant.

(2) The expense and inconvenience involved in defending an action brought in a district that is remote from the place where the defendant is located has the tendency to discourage the defense of the action and would in effect result in the deprivation of resort to due process.

(3) Persons residing in New York City and vicinity are afforded an undue advantage over those domiciled or doing business in other parts of our Country, resulting in the denial of equal protection, due process and equal rights under the law as between citizens of New York and citizens of other States.

State of Kansas ex rel. Beck v. *Occidental Life Ins. Co.* (C. C. A. Kan. 1938) 95 F. (2d) 1935, cert. den. 305 U. S. 603;
Ginsberg v. *Lindel* (C. C. A. Iowa) 107 F. (2d) 721.

Conclusion

We have discussed hereinabove, some of the distinctions between the case at bar and *Smolowe* v. *Delendo, supra.* They may be summarized as follows:

In the first place, some of the essential facts and circumstances in this case differ from those in the *Smolowe* case:

(1) The *Smolowe* case involved a single trading period of less than six months, while the case at bar is concerned with stock transactions that continued in the course of a period of just about three years.

(2) The *Smolowe* case dealt with officers who are presumed to have or to have acquired "inside information". The officers in the *Smolowe* case were at the same time "beneficial owners" as defined in the Act. However, as this Court there pointed out (136 F. (2d) at p. 240):

> "Here, however, the asserted liability seems more of an incident of the holding of office than of the ownership of stock."

In the case at bar, liability is asserted against the defendant as beneficial owner and not as an officer and director, in neither of which two official capacities defendant served. The likelihood of the existence of unfair advantage in trading does not attach to a stockholder to the extent that it may be held to be associated with an officer or director and the presumption of the possession of inside information as to an officer and director cannot be indulged in with respect to a stockholder, especially one who, though holding stock in the neighborhood of the 10 per cent mark, is still by far a minority stockholder.

In the second place, additional issues, not considered in the *Smolowe* case have been raised in the case at bar, such as:

(1) Venue and jurisdiction.

(2) The application by the District Court of the six months rule.

(3) The submission by defendant of a computation based upon his conception of the six months rule.

And finally, it will be found that similar contentions to those advanced in the *Smolowe* case have been buttressed by additional and different considerations as they have also been set forth in a different setting.

In an attempt to fix the maximum amount with which defendant could be charged, we formulated a method within the frame-work of all of the steps established by the lower Courts in the *Smolowe* case, and differing only from that relied upon by plaintiffs in the fact that instead of going six months backward and six months forward from a sale to a purchase, or from a purchase to a sale, as was done by plaintiffs, we have gone three months backward and three months forward. Under our way of measuring the six month interval contemplated by the statute, the profits have been found to amount to $117,137.71. It is respectively submitted that in any event, defendant should not be held liable for a higher amount.

As explained hereinabove, the foregoing procedure does not take into account the objections interposed by defendant to plaintiffs' method of computing profit, *i.e.*, highest out against lowest in, or lowest in against highest out, and our advocacy of the income tax rule whose effective functioning has been tested in years of successful operation. In income tax procedure losses are taken into consideration.

The learned Master, in his report, referred to the statute as being "somewhat harsh and severe" (R. 53). There can be no dissent with such statement, especially in the face of the fact that defendant's tradings in the stock of the corporation during the three year period embraced in this action resulted in an "economic", *i.e.*, total loss, of $401,627.42 (R. 29.30, 37). However, we do not find any indication of the intention of the Congress to be harsh or severe to the extent of compelling a stockholder to pay to the corporation what are denominated as profits but which in fact do not constitute and do not have the characteristics of profits. If the Congress wanted to carry harshness and severity to that point, if its intentions were to deviate from the income tax rule, it would have adhered to the phraseology of the draft of the Act or it would have otherwise expressed itself in that regard in clear and positive language. What the Congress was after were the real and actual profits, not fictitious profits, and it was the deprivation of the real and actual profits that the Congress regarded as a sufficient deterrent. You do not find actual profits without deducting losses.

We respectfully submit that the impact of Section 16(b) as heretofore construed, resulting in consequences unforeseen and unintended by the Congress requires a restatement of the rules and principles that should govern the determination of profits, both as to the time element—(six months rule) and as to the arithmetical computation (matching of sales with purchases, and purchases with sales) with particular reference to trading periods extending over an interval in excess of a single period of less than six months.

At the same time, we respectfully urge that on the basis of improper venue, absence of jurisdiction and lack of constitutionality, or upon any one of said grounds, the action herein should have been dismissed.

It is therefore respectfully submitted that this case is one calling for the exercise by this Court of its supervisory powers of granting a Writ of Certiorari and thereupon to review the judgment and decree of the Court below and to take the following action:

1. Reverse the order denying defendant's motion for the dismissal of the action dated April 15, 1947;

2. Reverse the order granting summary judgment against defendant dated May 19, 1947;

3. Reverse the judgment in favor of plaintiff Missouri-Kansas-Texas Railroad Company and against defendant Edward N. Claughton filed November 29, 1949;

4. Dismiss the complaint herein and the action founded thereon upon the grounds of improper venue, lack of jurisdiction, and unconstitutionality, or upon any of those grounds; or

5. Modify the judgment entered herein by reducing the amount of recoverable profits to the sum of $117,137.71; or

6. Grant a new trial with directions that damages be assessed upon the basis of the income tax rule.

Respectfully submitted,

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